IMPLEMENTING PORTABLE ALPHA STRATEGIES

Strategic Investment Group®

Fiduciary Insights

FIDUCIARIES HAVE SEVERAL MEANS OF IMPLEMENTING PORTABLE ALPHA STRATEGIES, RANGING FROM INTERNALLY MANAGED ACCOUNTS TO TURNKEY FUNDS . To sort out the various options, and to avoid letting implementation concerns stymie efforts to introduce a promising source of value added, a framework for thinking about each approach's pros and cons can be useful.

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Choosing a Portable Alpha Structure

Portable alpha strategies are appealing because they enable investors to generate alpha from any asset class or strategy and to transport it to other market exposures. Institutions quickly discover, however, that fundamental decisions about implementation are required before they can invest. To begin with, there are various ways to structure the alpha (value-added over a market benchmark) and beta (market exposure) of a portable alpha program. The two elements can be obtained either separately or together, in simple or complex combinations, from one provider or many. Each choice brings governance, operational, and cost considerations, which vary in importance in accordance with each investor's unique set of needs and capabilities.

A diagram such as the one shown in Exhibit 1 can help identify the main options. For example, an institution can obtain the alpha by finding, investigating, and hiring one or more hedge funds on its own, and then supervising the collection of funds itself. Alternatively, it can outsource the fund selection and monitoring work by investing in a fund of hedge funds. A third route is to invest directly in a multi-strategy hedge fund, which comprises diverse strategies run by one management group inside a single fund. All three methods can offer diversification of alpha sources, the adequacy of which will depend on how well the alpha pools are designed.

The Alpha Choices

When it comes to hiring hedge funds, the do-it-yourself route can save money but involves some risks, not unlike building your own house. Institutions that opt to do this can minimize their costs, but will need to spend some or all of those savings on training in-house personnel (or recruiting outside expertise), and obtaining analytical tools. With more than 10,000 hedge funds of every kind, constructing a well-diversified hedge fund pool is a full-time job. Hedge funds are known for their opacity, which makes allocating assets between various managers and strategies without adding unidentified and

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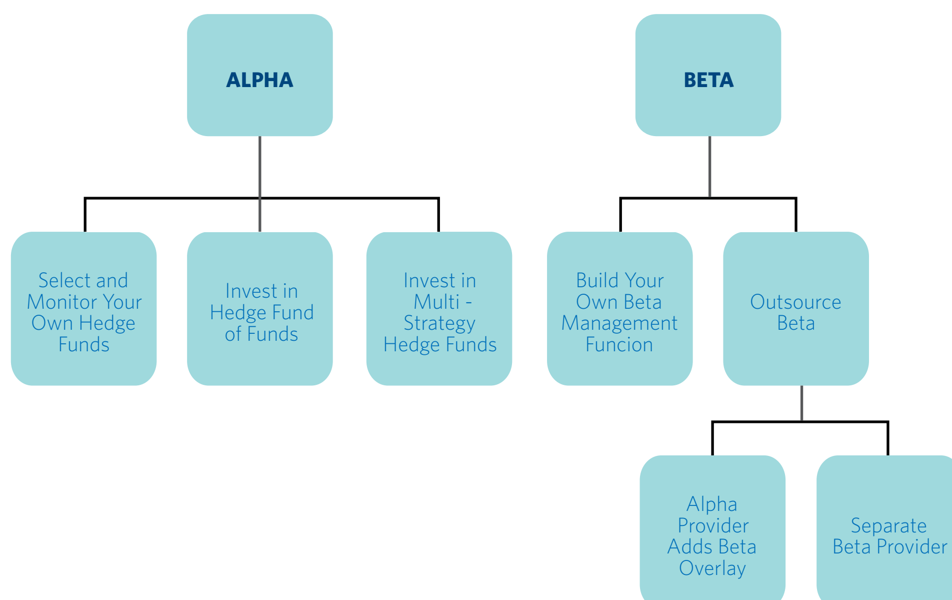
EXHIBIT 1:
Major Options for Structuring a Portable Alpha Program



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undesirable beta risk very difficult. Moreover, internal staff need the skills and experience to select and monitor hedge funds with multiple and evolving strategies — and to measure their risks — in a manner consistent with prudent fiduciary standards for these types of investments.

The desire to avoid adding staff or adding to an internal staff's ample workload can lead many institutions to prefer investing in a fund of funds. This option effectively offloads fund selection onto an experienced third party. Picking a fund of funds is not simple — particularly one that is appropriate for portable alpha programs. It is key to select a provider that has invested sufficient effort in developing systems to evaluate and monitor the risks embedded in a diversified group of hedged strategies. Cost consequences are an important issue when considering these vehicles. Any fund of funds will add a new layer of fees for selection and monitoring services to those of its underlying hedge funds, and it too will require some supervision by the hiring institution. Typically, however, this is less onerous than monitoring hedge funds yourself.

A multi-strategy hedge fund often eliminatesexplicit fee layering, and can be less expensive than a fund of funds. In a multi-strategy fund, a single provider offers an array of alpha-generating strategies under one roof. This structure has the natural advantage of control, by enabling one party with complete information about all of the underlying holdings to integrate and coordinate the aggregate risks produced by the various strategies. On the other hand, this alternative can suffer from a lack of manager diversification, since a single provider — even one with many strategies — may have one dominant perspective on markets that tends to drive its decisions. Worse still is the risk of intra-fund contagion where profitable positions may be liquidated to finance failing strategies. Theoretically, and occasionally even in reality, a single multi-strategy hedge fund can lead to a total loss of one's investment, whereas the probability of total loss is quite low in a multi-manager fund of funds.

The Beta Choices

When it comes to adding the beta component to a portable alpha program, the do-it-yourself approach may not be worth the trouble for most institutions. Beta is cheap and can be purchased through futures or swaps. A few institutions, typically larger ones, are already set up to handle such instruments and want the flexibility to control market exposures directly in-house. The majority of investors, however, will probably find that the significant administrative setup costs associated with derivatives — adequate back office resources, dedicated compliance and control mechanisms, specialized trading and custody accounts — outweigh the small cost savings available.

It is also possible to hire a manager just to provide beta exposure to a separately managed alpha portfolio. This choice naturally comes at additional expense, and the investing institution must furnish specific details of the alpha portfolio continuously to the beta manager. Most institutions do not want to be in the role of data provider.

To avoid such burdens, it is often more efficient administratively to simply expand the role of the alpha manager to include overlaying its alpha portfolio with beta exposure. A multi-strategy hedge fund or a fund of funds may offer to manage the beta overlay as a free service or at low cost, and is likely to have access to more timely and detailed information on the alpha portfolio. These valuable insights, coupled with sophisticated platform integrated analytical

tools, allow for managing the beta exposures efficiently.

Bundling, or A La Carte?

Turnkey portable alpha funds, which combine a diversified alpha pool with actively managed beta exposures, are now available. Such bundled approaches to managing alpha and beta together have several inherent advantages. They ensure coordination, flexibility, and clear accountability for the total result of a portable alpha strategy. Costs are often lower, and communications between the investing institution and the portable alpha manager are simpler than they are for any of the alternative methods. The full spectrum of the manager's skills and insights can be brought to bear on the entire portable alpha strategy.

Whether or not an institution should seek a bundled solution will depend on its objectives. The fiduciaries will find the answers by asking themselves what they are trying to achieve by implementing a portable alpha strategy, and what the strategy will demand in order to be implemented effectively. For example, some objectives (such as increasing the active risk in a U.S. equity portfolio) may be met by tapping into narrow expertise in a particular asset class; others (such as transporting active risk from less efficient to more efficient asset segments) require a breadth of experience in allocating globally across several asset classes.

Organizational Readiness

An institution's governance structure often strongly influences its choices in setting up a portable alpha program. In order to run such a complex strategy with internal resources, staff members need not only high levels of expertise, but also sufficient authority to actively manage and monitor investments. In many cases, the institution is unwilling to delegate the necessary direct investment authority to internal staff, or the staff is unprepared or untrained for taking on the additional workload.

Readiness to assume the operational tasks involved in a portable alpha program is a common sticking point. A lot of specialized organizational infrastructure — dedicated to such critical functions as legal, compliance, trading, monitoring, and reporting — is needed to support and control investment operations. To run a portable alpha program using futures for the beta exposure, for example, an institution must handle daily cash transactions to satisfy margin requirements. To trade other derivatives, investors must negotiate complex legal contracts with their counterparties, such as the International Swaps and Derivatives Association (ISDA) Master Agreement, a notoriously complicated document which takes a specialized lawyer to decipher. The cost of managing these critical housekeeping tasks, though often overlooked, is part of the value added by providers of bundled products, in addition to their investment experience.

Fiduciaries of ERISA plans, endowments, and foundations have special considerations when they set up a hedge fund pool for a portable alpha program. To avoid incurring unrelated business taxable income (UBTI), which may be generated by the debt-financed investments that hedge funds typically use, such institutions will often prefer offshore hedge funds. Also, many hedge funds are

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wary about taking ERISA money, limiting the amount they will accept to less than 25% of their total assets, the point beyond which a hedge fund becomes “plan assets” subject to specific ERISA and Department of Labor regulations. Partnering with a provider who has set up structures appropriate to various types of investors can ease the administrative burden an à la carte program might entail.

Fit the Program to the Institution

Deciding how to launch a portable alpha strategy is a familiar problem, because it is similar to one investment managers and fiduciaries faced years ago when they ventured outside traditional asset classes into the unfamiliar territory of emerging markets, private equity, or other alternatives. Those pioneering institutions also had a “build or buy” choice of developing their own programs internally or hiring outside expertise, either in pieces or as a bundled service. Their seminal decisions had lasting effects on the size, shape, performance, and know-how of the organizations themselves. Likewise, the way fiduciaries implement portable alpha has a big impact on their institutions. Their choices must be guided by realistic self-appraisal, so that the costs in money and manpower are a good fit with the institution’s internal capabilities. Fortunately, there are several options available; it would be a shame if the mechanics of implementation discouraged institutions from taking advantage of a very attractive source of value added.

Strategic Investment Group

Strategic, a pioneer in dedicated Outsourced CIO (OCIO) solutions since 1987, offers a comprehensive service platform for managing customized portfolios for institutional and private investors. Our proprietary process combines active portfolio management, rigorous risk management, and open architecture manager selection.

Strategic functions as our clients' investment partner and co-fiduciary, effectively becoming an extension of their resources. Clients are then free to focus on their core businesses, while we focus on providing the highly specialized portfolio management expertise that clients need to meet their investment goals. Depending on a client's needs and preferences, Strategic can orchestrate the management of an entire portfolio comprising multiple asset classes, focus on specific asset classes, such as alternatives (e.g., hedge funds, real estate, and/or private equity) or international investments, or manage strategies with high potential for adding value (e.g., portable alpha through investor-friendly turnkey structures). Customized liability-driven investing (LDI) solutions, whether through an integrated total portfolio approach or a targeted long-duration strategy, are also available, as are solutions that address mission-related investment objectives.

We strive to build enduring partnerships with our clients by strengthening their investment programs through a dynamic, value-enhancing investment process, sound governance framework, and world class client service. Our mission is to empower investors through experience, innovation, and excellence.

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